

OFAC Designates Tornado Cash as a Sanctioned Entity as Federal Government Continues to Increase Regulation of Decentralized Financial Platforms

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On Aug. 8, the U.S. Treasury Department's Office of Foreign Assets Control (OFAC) sanctioned cryptocurrency mixer Tornado Cash for allegedly helping launder more than \$7 billion worth of cryptocurrency over three years.¹ OFAC's designation of Tornado Cash as a sanctioned entity is one of the latest examples of the federal government's increased regulation of decentralized financial platforms. Just one month after OFAC issued the sanctions, six Tornado Cash investors are suing OFAC, alleging that OFAC exceeded its statutory authority. Financially backed by the digital currency platform Coinbase, the investor-plaintiffs seek declaratory and injunctive relief under both the U.S. Constitution and the Administrative Procedure Act. On Sept. 13, OFAC issued clarification regarding both prohibited and permissible activity of Tornado Cash transactions initiated prior to its Aug. 8 designation.

In addition, on Sept. 9, Securities and Exchange Commission Chair Gary Gensler announced he was working with Congress to enact legislation further regulating cryptocurrency.

Cryptocurrency transactions are recorded on a blockchain, which allows the transfer of assets to be digitally traced. As a cryptocurrency mixer, however, Tornado Cash contravenes this tracking

function by combining streams of digital asset transfers and obscuring each asset's source. While this feature increases privacy of cryptocurrency transactions, it also makes it harder for law enforcement officials to track transactions. To curtail illegal use of Tornado Cash's platform, OFAC's designation prohibits transactions to or from Tornado Cash, freezes all assets sitting in Tornado Cash, and bans the cryptocurrency mixer's very code.

The plaintiffs assert that these restrictions penalize all digital currency users rather than specific bad actors. Moreover, Tornado Cash is a set of "smart contracts," which are pieces of code that operate independently of any person or entity. Thus, unlike Blender.io, another cryptocurrency mixer OFAC has sanctioned, Tornado Cash is a noncustodial software application, not an entity in the traditional sense of the term. Consequently, the plaintiffs are challenging the designation on First Amendment free speech grounds, arguing that OFAC lacks the authority to restrict access to a software program because software is a form of speech.

Seemingly in response to the lawsuit, on Sept. 13, OFAC clarified that interacting with open source code in a way that does not involve a prohibited

¹ <https://home.treasury.gov/news/press-releases/jy0916>.

transaction with Tornado Cash is allowed. Specifically, it is permissible to copy the open source code and make it available online for others to view as well as to discuss, teach about, or include open source code in written publications.

The Tornado Cash designation reflects the recent increased scrutiny of cryptocurrency transactions by OFAC and other U.S. regulatory and enforcement agencies, including the Financial Crimes Enforcement Network (FinCEN). In parallel with this increased enforcement attention, OFAC and FinCEN have published guidance for parties engaging in virtual currency transactions, effectively putting the industry on notice that the U.S. government will take action against those that seek to evade U.S. sanctions. The Tornado Cash designation illustrates that OFAC believes even technical protocols can be sanctioned.

Given the latest OFAC enforcement, cryptocurrency holders should take note of the following:

- Absent a specific license from OFAC, U.S. persons cannot engage in transactions involving identified Tornado Cash virtual currency wallet addresses or any other party designated by OFAC.²
- Transactions involving parties, including cryptocurrency exchanges, located in embargoed regions (currently Cuba, Iran, North Korea, Syria, and the Crimea, Donetsk, and Luhansk regions of Ukraine) are prohibited unless authorized by OFAC through a license.
- If U.S. persons initiate or otherwise engage in a transaction with Tornado Cash, including through one of its wallet addresses, such a transaction would violate U.S. sanctions prohibitions unless exempt or authorized by OFAC.
- For transactions involving Tornado Cash that were initiated prior to its designation on Aug. 8 but not completed by the date of designation, U.S. persons or persons conducting transactions within U.S. jurisdiction may request a specific license from OFAC to engage in transactions involving the subject virtual currency.
- Sanctions do not prevent U.S. persons from visiting the internet archives for the Tornado Cash historical website or visiting the Tornado Cash website if it again becomes active on the internet.³

Violations of OFAC sanctions can carry significant liability, including fines of more than \$300,000 per violating transaction (or twice the value of the transaction, whichever is greater), and criminal

penalties in cases where the violating party intended to violate the sanctions. Additionally, OFAC settlements, which include detailed reporting of a company's violating behavior, are frequently published and can cause reputational damage to a company.

Individuals and companies involved in virtual currency transactions should implement compliance procedures to confirm that any such transactions do not involve a designated party or a party located in an embargoed region. Making reasonable efforts to comply with regulations not only reduces the risk of a violation but is also considered a mitigating factor by OFAC in the event of an inadvertent violation. If a party believes they may have violated sanctions laws, they should consider, in consultation with their counsel, whether a voluntary disclosure to OFAC is appropriate. Voluntary disclosures can provide certainty regarding potential violations and also are considered mitigating factors by OFAC in any penalty assessment, but the party needs to provide a complete factual description and legal analysis for OFAC to consider.

² <https://home.treasury.gov/policy-issues/financial-sanctions/faqs/1077>.

³ <https://home.treasury.gov/policy-issues/financial-sanctions/faqs/1076>.

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